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Dear Ms Ram

**Exposure draft law: Multinational Tax Integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions**

PwC welcomes the opportunity to make this submission in relation to the Exposure Draft (**ED**) and Explanatory Materials (**EM**) relating to “Multinational Tax Integrity – denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions” (**Draft Law**) released for consultation by the Treasury on 31 March 2023.

As stated in our previous submission to Treasury on 2 September 2022, this new intangible integrity measure appears to be an Australian unilateral measure that has inconsistencies with Australia’s multilateral commitments to the OECD ‘two-pillar’ solution to address the tax challenges of the digitalisation of the economy. In particular the Global Anti-Base Erosion (**GloBE**) Rules (**Pillar Two**) sets a 15% global minimum effective tax rate which is designed to ensure minimum levels of tax are paid on low-taxed income and under-taxed payments within the framework of a multilateral approach.

There are a range of aspects that require careful consideration before the Draft Law is introduced into Parliament. These have been considered in detail in the Appendices. However, there are two critical aspects that require clarification and refinement as an immediate priority before a 1 July 2023 start date, namely:

- The definitional boundaries of a “low corporate tax jurisdiction” (**LCTJ**).
- The circumstances in which an arrangement can be asserted by the Commissioner of Taxation as having been “mischaracterised”, having regard to the future administration of the intangible integrity measure.

**1) The low corporate tax jurisdiction definition**

As currently drafted, on a broad interpretation, the LCTJ definition could apply to a majority of foreign countries due to the qualifications that have been devised in proposed subsection 960-258(2). The current LCTJ definition could include tax treaty partners and major trading partners, rather than being confined to the intended target being foreign countries with low rate corporate tax regimes.

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As a related issue, the drafting of the LCTJ definition does not take into account circumstances where international tax concepts operate to actually impose additional taxes on income that initially appear subject to low rates of corporate tax.

Specifically, the following concepts need to be appropriately factored into the LCTJ definition (either alone or in combination):

1. **Controlled Foreign Company (CFC) taxes:** Top-up taxes paid on the income in question due to the operation of CFC rules.
  - Similar recognition for CFC taxes paid featured in the enactment of Australia's Diverted Profits Tax (**DPT**) and, most recently, Australia's hybrid mismatch rules.
2. **Sub-national income taxes:** State and municipal income taxes also paid on the income in question.
  - Similar recognition for state and municipal income taxes paid features in Australia's targeted integrity rule under the hybrid mismatch rules.
3. **Look-through taxation:** Taxes paid on the income in question by a foreign entity/shareholder/partner. This can arise for foreign branches or disregarded/"flow-through" entities held by shareholders/partners in high tax jurisdictions.
4. **Royalty Withholding Tax (RWHT):** Final taxes imposed on the income in question by Australia due to RWHT obligations.
5. **Pillar Two:** Top-up taxes paid on the income in question as a consequence of the adoption of Pillar Two by foreign countries, including due to the operation of a Qualifying Domestic Minimum Top-up Tax (**QDMTT**) regime and the Income Inclusion Rule (**IIR**).
  - The Draft Law is silent on the interaction with Pillar Two. However, the Multinational Entity Tax Transparency Exposure Draft released by the Government on 6 April 2023 (i.e. one week after the Draft Law) expressly references requirements based on the Pillar Two Model Rules (notwithstanding the Australian Government has not yet made a formal announcement regarding its implementation of the Pillar Two Model Rules).
6. **Alternative foreign tax definition (i.e. "covered taxes"):** Multilateral consideration has been given within Pillar Two to the definition of "covered taxes", and these concepts could be adopted for consistency.
7. **Ultimate parent country:** Exclusions for income derived in the same country that the ultimate parent entity (**UPE**) is headquartered in, given this aligns to holding intangibles in a jurisdiction with sufficient economic substance.
  - A similar exclusion features in Australia's targeted integrity rule under the hybrid mismatch rules.

If policy decisions conclude that any or all of these circumstances will not be factored into the definition of LCTJ introduced into Parliament, then the corollary needs to be that clear statements are included in the explanatory memorandum to outline the policy intent on these aspects (in order to assist with the administration of these rules in the future).

## 2) Mischaracterisation

The lack of clarity surrounding the new concept of mischaracterisation is compounded by the broad drafting of an 'intangible' and the 'exploitation' of intangibles (covered in the Appendices).

The Draft Law appears to apply to payments identified as being made for particular things under a contract (such as the purchase of services or tangible goods) where broadly:

- that contract also provides rights to exploit intangible assets;
- the Australian SGE exploits intangible assets in substance; or
- the Australian SGE neither obtains rights to exploit, nor exploits intangible assets in substance but receives a service where intangible assets are exploited by the service provider or other foreign associate.

This is supported by paragraph 1.37 of the EM which states “... *the arrangement also results in the SGE or another entity exploiting, or acquiring the right to exploit, an intangible asset ...*”. It is then contemplated that the denial of deductions could apply in whole or in part, depending on the interpretation for apportionment.

The circumstances in which a payment for something else risks being labelled as a mischaracterisation is in no way clear or certain. There is only one example in the EM, yet this new concept of mischaracterisation (that will likely be very dependent on the particular facts and circumstances) warrants the inclusion of several examples in order to assist with interpreting the Draft Law.

Additional examples are also needed for the task of assessing whether a payment is a “genuine arrangement where there is no tax avoidance behaviour” (see paragraph 1.47 of the EM) as this concept only features in the EM rather than in the Draft Law itself. Such inconsistency should be resolved by also reflecting this concept in the eventual legislation.

## 3) Other critical issues

There are a number of other critical issues with the Draft Law which, if not addressed, will result in significant uncertainty and an increased compliance burden for taxpayers, that will hinder the competitiveness of businesses operating in Australia:

- **Purpose/nexus tests:** The lack of a purpose test or substance based carve out means the Draft Law has no mechanism to distinguish between arrangements that were entered into for genuine commercial purposes or otherwise for a tax avoidance purpose.
- **Tracing:** The problematic requirement to trace payments beyond the direct recipient with no nexus requirement to the initial payment.

- **Apportionment:** The Draft Law contemplates the apportionment of payments in determining whether there is any denial of deductions but no guidance is provided on appropriate methodologies of apportioning payments under the provisions.
- **Interaction with other provisions in the tax law:** The ordering and interaction of the Draft Law with pre-existing integrity provisions in the Australian tax law
- **Penalties:** The EM refers to a shortfall penalty provision that is being considered as a punitive measure. This has the potential to be draconian given the LCTJ ignores other foreign taxes paid, the lack of a purpose test, the duplication with other integrity rules, and the inability to consult on the unannounced concepts prior to 1 July 2023.
- **Lack of guidance:** The lack of detail and examples in the EM and the time it may take for the Commissioner of Taxation to issue administrative guidance as to how the law is to be administered. Even though the Draft Law sits outside of the general anti-avoidance rules (such that procedures required under PSLA 2005/24 do not apply), escalation procedures within the Australian Taxation Office (**ATO**) should still be established so that the provisions involve appropriate oversight at senior levels before deductions can be denied.
- **Application date:** Where there is no further public consultation on the Draft Law once a Bill is tabled before Parliament, then the start date should be set as 6-12 months from the date of Royal Assent. Alternatively, aspects that are absent from the Draft Law (such as increased penalties) should be introduced once sufficient public consultation has taken place. Consideration should also be given to instances that should be grandfathered (for example, in the case of a group acquisition of intangible assets) or introducing a substance based carve-out to avoid retrospective effect of the measure.
- **Sunsetting:** This specific integrity rule should not continue in force once Australia has implemented Pillar Two rules.

PwC acknowledges the desire for Australia to possess adequate legislative means to counteract behaviours with the potential to impermissibly erode the Australian tax base

However, in our view, it would be worth clarifying how and why an additional anti-avoidance measure is needed given existing general anti-avoidance rules contained in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**) and specific integrity rules designed to address the potential for base erosion and profit shifting (**BEPS**) already included in the Australian tax legislation which adopt a mix of domestic, G20 and OECD led BEPS reforms such as:

- hybrid mismatch rules,
- the Multinational Anti-Avoidance Law (**MAAL**),
- the DPT,
- Country by Country Reporting (**CbCR**),
- information sharing with other jurisdictions, and
- adoption of the Multilateral Instrument (**MLI**).



The Draft Law is a far-reaching duplication that has the potential to impact businesses operating in Australia, consumers and Australia's bilateral relationships.

We welcome the opportunity to discuss our submission with you and to engage in further consultation as the specific measures are designed and refined. If you have any questions please contact [Jonathan Malone](#) on 0408 828 997, [Ross Malone](#) on 0406 793 901, [Jayde Thompson](#) on 0403 678 059 or [Angela Danieletto](#) on 0410 510 089.

Yours sincerely

A handwritten signature in blue ink that reads 'CMorris'.

Chris Morris  
Australian Tax Leader



## **Appendices**

Further detail on the matters raised above and other comments are considered in Appendices as follows:

- Appendix 1 - Matters relating to determining a LCTJ.
- Appendix 2 - Matters relating to commercial arrangements and mischaracterisation.
- Appendix 3 - Matters relating to practical compliance and administration.
- Appendix 4 - Other matters for consideration.

## **Appendix 1 - Matters relating to determining a LCTJ**

We consider the LCTJ definition to be one of the most critical issues in the Draft Law. Whilst we acknowledge the likely intent to base this definition on a foreign country's national (i.e. headline) tax rate, there are notable complexities in how this is to be determined taking into account the broad drafting of proposed subsection 960-258(2).

As currently drafted, the LCTJ definition could apply to a majority of foreign countries due to the qualifications devised in paragraphs 960-258(2)(a) to (e). For example, even if a foreign country has a national tax rate that is greater than 15%, this rate may reduce to (i) nil if there is no income tax payable on a particular amount of income (i.e. there is an exemption from tax on certain types of income), or (ii) the lowest rate if the jurisdiction has "different rates of income tax for different types of income" (i.e. there is an incentive).

Interpreted broadly, a LCTJ could include tax treaty partners and major trading partners with high headline rates of tax, rather than being confined to the intended target being foreign countries with low rate corporate tax regimes.

Importantly, the drafting of the LCTJ definition also does not take into account circumstances where international tax concepts actually impose (or will soon impose in the case of Pillar Two) additional taxes on income that initially appear subject to low rates of corporate tax.

Accordingly, there is currently no ability in the Draft Law to take into account the total tax burden (due to potential multiple layers of taxation) in determining whether income has been derived in a LCTJ.

### ***(a) CFC taxes paid should be taken into account in determining whether income has been subject to sufficient tax***

Under the drafted paragraph 26-110(2)(c), deductions would still be denied in connection to income that is *prima facie* derived in a LCTJ but is subject to an overall income tax rate of 15% or more due to the application of a CFC attribution regime in another jurisdiction (including Australia). This is because paragraph 26-110(2)(c) merely requires the income to be derived in a LCTJ to be in scope and does not account for the potential effects of CFC attribution.

Consequently, income that has been subject to sufficient tax due to CFC attribution would still be at risk of being impacted under the Draft Law. The policy approach should be determined with regard to the Australian Government's commitment to the OECD BEPS Initiatives with respect to *Action Item 3 - Designing Effective Controlled Foreign Company Rules*.

Further, having regard to CFC attribution is consistent with other integrity measures in the Australian tax law. For example, the effects of CFC taxation is included in:

- The definition of "subject to foreign income tax" under subsection 832-130(5) of the hybrid mismatch rules,

- Determining whether a payment has been subject to at least 10% tax<sup>1</sup> under section 832-725 of the targeted integrity rule of the hybrid mismatch rules, and
- The application of the DPT to a scheme, having regard to the modifications in subsections 177J(6) and (6A) of the ITAA 1936.

The LCTJ definition should be amended to include CFC taxes in the determination of whether income has been subject to foreign tax at a rate of at least 15% or less than 15%. This would create greater consistency with other integrity measures (as outlined above) as well as ensuring the proposed measure is appropriately targeted to only apply to genuine scenarios where, taking into account the full tax burden, the income is taxed below 15%.

***(b) The rate of foreign tax should have regard to ‘sub-national’ income taxes***

Paragraph 1.55 of the EM states that only the national headline rate of a jurisdiction is required to be taken into account for determining whether a jurisdiction is a LCTJ for the purposes of the measure. However, due to the differences between jurisdictions and their respective income tax systems, income taxes can also be levied on an entity's income at a local/municipal/state/cantonal level as well, resulting in income being subject to an overall income tax rate greater than the national headline rate.

Jurisdictions that impose income tax at multiple levels of government may also have a lower national headline rate, to account for this imposition, than jurisdictions that only impose corporate income tax at the national level.

To allowing for the aggregation of income tax at multiple levels within a jurisdiction is consistent with other Australian integrity measures, including, for example:

- The targeted integrity rule in subsection 832-725(1A) specifically includes municipal and state taxes in working out what is subject to foreign income tax.
- The definition of “foreign income tax” in section 770-15, that is used for purposes of the “sufficient foreign tax test” in the DPT rules, includes tax on income, profits or gains (of revenue or capital nature) or any other tax that is subject to a double tax agreement. The foreign law may be at the level of a national or sub-national government.<sup>2</sup>

The Draft Law should be amended to ensure that a jurisdiction which has sub-national layers of income tax but, where the aggregated income tax rate is at least 15%, is not inappropriately characterised as a LCTJ. This would align with the approach taken under the policy decisions previously adopted for the targeted integrity rule in Subdivision 832-J within the hybrid mismatch rules.

***(c) The Draft Law should account for look-through taxation (i.e. where tax is paid on the income in question by a foreign entity/shareholder/partner)***

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<sup>1</sup> Subparagraph 832-725(1)(g)(i).

<sup>2</sup> This was also acknowledged by the Commissioner of Taxation in the Law Companion Ruling (LCR) 2018/6.



Look-through taxation can arise for foreign branches, permanent establishments (**PE**) or disregarded/"flow-through" entities based in a LCTJ, but that are held by foreign shareholders/partners who are tax residents in high tax jurisdictions.

The Draft Law fails to account for income that is derived through a branch/PE or a "flow-through"/disregarded entity (an entity where the investors are liable for taxation on the entity's income and profits, such as a partnership) in a LCTJ, but is subject to a sufficient level of income tax in the hands of the foreign investor entity (e.g. shareholder/partner) in the foreign investor's jurisdiction of tax residency.

Multinational groups commonly use branches/PEs or "flow-through"/disregarded entities. The Draft law could better account for these situations as it only focuses on where income is derived, rather than the total tax paid in respect of the income. The concern relates to income that is derived in a LCTJ but has been subject to income tax of at least 15% in another jurisdiction that will be impacted under the Draft Law, and subject to double taxation (and in some cases, triple taxation).

The Draft Law should be amended to take into account look-through taxation, by accounting for the taxing outcomes of income derived through a branch/PE/ "flow-through"/disregarded entity where such income has been subject to tax in the hands of the entity's foreign investors in another jurisdiction.

***(d) RWHT paid should be taken into account in determining whether income has been subject to sufficient tax***

The Draft Law could better factor in amounts of withholding tax paid (which is a final tax) with respect to a payment and/or income derived in a LCTJ. Consequently, the Draft Law will capture income that is *prima facie* derived in a LCTJ, despite withholding taxes paid with respect to the deductible payments and/or income, increasing the overall rate of tax the payments/income is subject to, including when that rate is at least 15%.

If amounts of withholding tax are not taken into account (by way of either an exemption or revisions to the current definition), then income derived in a LCTJ that has been subject to income tax of at least 15% due to amounts of withholding tax would be at risk of being in scope of the measure and subject to double taxation, and/or an amount of deduction may be denied that is greater than the actual shortfall in sufficient taxation once amount of withholding taxes are taken into account.

Having regard to the effects of withholding tax would be consistent with concepts reflected within the sufficient foreign tax test in section 177L within the DPT rules (see subsection 177L(7)) of the ITAA 1936.

Any withholding tax paid should be taken into account in determining whether a sufficient amount of income tax has been paid, or to reduce the potential denial of deductions with respect to a shortfall of income tax imposed on the income. This would also ensure alignment with the approach adopted by other integrity rules such as the DPT.

**(e) A LCTJ should not include foreign countries that have implemented the OECD developed Pillar Two Model Rules or a QDMTT**

The Draft Law should take into account the upcoming changes from the Pillar Two Framework, particularly with respect to QDMTT, IIR and the Undertaxed Profits Rule (**UTPR**), when it comes to determining whether income has been derived in a LCTJ. Income that is subject to an aggregated tax rate of 15% due to the application of a QDMTT, IIR or UTPR may be unfairly impacted under the Draft Law where it is *prima facie* derived in a jurisdiction with a headline rate below 15%.

The Pillar Two Framework is the result of several years of multilateral discussion and negotiation to find a global consensus on ensuring a minimum rate of taxation of multinational groups, in a way that balances tax certainty, equity, and sovereignty. Successive Australian Governments have previously stated their commitment to the OECD BEPS Initiative, including the current Government's plans aligned to *Action Item 4 - Limitation of Interest Deductions*, along with its active participation in the development of the Pillar Two Framework.<sup>3</sup>

As the Pillar Two Framework aims to ensure income is subject to an effective tax rate (**ETR**) of at least 15%, it provides a more comprehensive and accurate assessment as to whether income has been subject to a sufficient amount of tax, as compared to the current approach under the Draft Law of relying on the headline rate (but with qualifications) in order to satisfy the definition of LCTJ.

The definition of LCTJ could instead acknowledge the application of an anticipated QDMTT in many jurisdictions, which will apply to income derived within those jurisdictions, to broadly ensure such income is subject to an ETR of at least 15%. Similarly, where income has been derived in a LCTJ and subject to tax under the IIR or UTPR of another jurisdiction, the application of that IIR or UTPR should ensure that the income is overall subject to an ETR of at least 15%.

Numerous jurisdictions, including those currently with headline rates below 15%, have already announced, or have commenced legislating QDMTT, IIR and/or UTPR provisions. As the taxpayer base of this measure (i.e. SGEs) is also largely in scope for the Pillar Two Rules, accounting for the effect of these provisions reduces significant risks of double taxation, as well as aligning with the mutual cooperation and tax certainty that underpins the multilateral initiative to introduce the Pillar Two Rules.

The Draft Law should be amended to ensure that any jurisdiction where income is subject to a QDMTT, IIR and/or UTPR whereby the aggregated income tax rate is at least 15% is not treated as a LCTJ. This would better serve the policy intent of the measure of "preventing large multinationals from securing an unfair tax advantage over other Australian businesses" whilst not significantly impacting the administrative burden that will be placed on taxpayers. This would also ensure the

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<sup>3</sup> The Treasury 2022, *Multinational Tax Integrity and Tax Transparency*, Australian Government, accessed April 2023, <https://treasury.gov.au/consultation/c2022-297736>.

acknowledgement of the work of 135+ countries, including Australia and many of our major trading partners, in developing this multilateral measure<sup>4</sup>.

***(f) There should be an exclusion for income derived in the same country as the UPE's headquarters***

The Draft Law can better recognise the economic substance behind the derivation of income that occurs in the same jurisdiction as that of its UPE. Sufficient economic substance should be present where the tax residency of the UPE aligns with the jurisdiction in which the intangible assets are being exploited; i.e. the income is not being derived with the primary intent of obtaining a tax advantage.

In failing to recognise these situations, income derived in a LCTJ will be impacted under the Draft Law, despite sufficient economic substance justifying its derivation in that jurisdiction. We note that paragraph 832-725(5)(a) of the targeted integrity rule under the hybrid mismatch rules recognises the economic substance of similar arrangements, and grants an exemption to its application in these circumstances.

The Draft Law should be amended to provide an exemption for income derived in the same jurisdiction as that of its UPE, similar to the exemption under paragraph 832-725(5)(a).

***(g) Required nexus of the exploitation income and the “low corporate tax jurisdiction”***

We are concerned that paragraph 26-110(2)(c) of the Draft Law does not require a nexus between the derivation of income from the exploitation of intangible assets, and that income being derived in a LCTJ; i.e., an SGE could be in scope of the provision where income is derived in a LCTJ, and income is derived from exploitation, but the exploitation income itself is derived in another jurisdiction to the LCTJ.

This does not appear to be the intended operation of the intangible integrity measure based on the wording contained in paragraph 1.34 of the EM, which states “income is derived in a low corporate tax jurisdiction... **from** the exploitation of the intangible asset, or a related intangible asset” [emphasis added].

Subparagraphs 26-110(2)(c)(iii) & (iv) should be amended so that it is clear that the provisions apply to the derivation of income in a LCTJ **from** directly or indirectly exploiting the intangible asset, or a related intangible asset **in that jurisdiction**.

***(h) Subsection 26-110(11) should be amended to appropriately link types of income and “low corporate tax jurisdictions”***

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<sup>4</sup> Additionally, the Treasury made comments in 2013 related to unilateral action in the context of the original BEPS program noting that “...unilateral action by one government should not adversely impact on another government and/or result in double taxation.” <https://treasury.gov.au/sites/default/files/2019-03/IssuesPaper.pdf>

Subsection 26-110(11), as currently drafted, does not specify what income is to be considered when determining if a jurisdiction is a LCTJ for the purposes of paragraph 26-110(2)(c). There is a risk that in applying the Draft Law to a jurisdiction with differing income tax rates applied to different sources of income (e.g. business activity, capital gains), that income from exploitation which is subject to an income tax rate of at least 15% may still be characterised as having been derived in a LCTJ due to other unconnected sources of income being subject to an income tax rate below 15% in that same jurisdiction.

Accordingly, subsection 26-110(11) should be amended to clearly state that when having regard to the income tax laws of a foreign country, it is only to the extent the income tax is applicable to the derived income mentioned under paragraph (2)(c) of an entity that is a SGE.

***(i) Other issues arising due to the broad definition of “low corporate tax jurisdiction” as drafted***

Other potential outcomes arising from the current, broadly drafted definition of LCTJ in the Draft Law include:

- It is unclear whether ‘income’ that is recognised for Australian income tax purposes, but not for the purposes of the applicable foreign income tax laws, could deem a jurisdiction to be a LCTJ. For example, countries that do not recognise or tax capital gains, such as New Zealand, could be characterised as a LCTJ if the activities in that foreign country results in a capital gain (for Australian income tax purposes).
- It is unclear if a foreign country may be deemed a LCTJ due to an associate entity which derives income which is tax-exempt under the laws of that jurisdiction; e.g. collective investment vehicles, sovereign entities, charitable entities.

## Appendix 2 - Matters relating to commercial arrangements and mischaracterisation

### ***No purpose or nexus test means arrangements with a genuine commercial purpose can be caught under these draft provisions***

We are concerned that due to the broad drafting of key concepts in the Draft Law, arrangements with a genuine commercial purpose, i.e. that were not entered into for a dominant purpose of avoiding Australian income tax, will be caught.

A dominant purpose requirement was included in the first announcement of this measure in 2019 which stated “A multinational can still get the tax deduction if the firm can substantiate to the Commissioner of Taxation that the royalty payments are not for the dominant purpose of tax avoidance.”<sup>5</sup> However, later media releases in 2022 and the August 2022 consultation paper were silent on this potential component.

As the measure is also intended to apply to offshore arrangements that do not have a direct nexus to the paying Australian entity, the potentially broad application of these provisions as drafted would similarly capture offshore arrangements with a genuine commercial purpose. It is unlikely that when entering these arrangements, foreign tax managers would be aware of the significant tax implications that could arise in respect of unconnected or remote payments made by an Australian SGE.

For example, arm’s length payments from an Australian entity to an offshore associate for routine administrative services could be caught under these draft provisions where the associate uses some form of internally generated know-how or software in providing the service, notwithstanding the commercial purpose and/or economic substance of the arrangement. Outcomes like these undermine the stated intent of the measure to be an anti-avoidance/integrity measure, as well creating a significant compliance burden for taxpayers through the number of transactions that will require examination, tracing and analysis.

The absence of a purpose test is inconsistent with most other anti-avoidance provisions in the Australian tax law which generally apply a purpose based test as a threshold requirement for the application of the relevant measure. For example:

- The “sole or dominant purpose test” applicable for the general anti-avoidance rule in Part IVA of the ITAA 1936.
- The “principal purpose test” in section 177J of the ITAA 1936 applicable for purposes of the DPT.
- The “principal purpose test” in section 177DA of the ITAA 1936 applicable for the purposes of the MAAL.
- The “principal purpose test” in the targeted integrity rule in Subdivision 832-J within the hybrid mismatch rules.

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<sup>5</sup> <https://www.jimchalmers.org/latest-news/media-releases/labor-will-crack-down-on-loopholes-for-multinationals/>

We recommend a purpose test be included in the provisions to appropriately set the boundaries of the scope so that arrangements with a genuine commercial purpose and economic substance are not caught, as contemplated in the first announcement of this measure in 2019. This would align the design of the measure with most other Australian income tax anti-avoidance provisions as outlined above.

Alternatively, we recommend the Draft Law is amended so an arrangement will only be in scope where the Australian SGE itself holds a right to exploit, or otherwise exploits, the intangible asset to which the income relates. This could be complimented with an integrity provision, similar to the 'structured arrangement' concept under section 832-210 within the hybrid mismatch rules to also deem in-scope arrangements where it is reasonable to conclude that the arrangement was entered into to circumvent application of the provision, and there is no reasonable commercial purpose or economic substance to the arrangement. Implementation of either of these recommendations could greatly reduce the potential compliance burden the measure as currently drafted presents to taxpayers.

#### **Taxpayer uncertainty and potential arrangements in scope heightened by broadly defined concepts in the Draft Law**

The terms 'intangible asset' and 'exploit' are intended to have a broad definition, and we accept that broad, principle-based drafting may be preferred for an integrity/anti-avoidance measure of this type.

However, without a purpose or nexus test such broadly defined terms significantly increase the potential scope of arrangements caught under the provisions as currently drafted, and make it difficult for taxpayers to review and adjust their arrangements to ensure that they are responding to the intent of the provisions, thereby leading to significant uncertainty from taxpayers.

If a purpose or nexus test is not included in the Draft Law, the definition of the terms 'intangible asset' and 'exploit' should be clarified to appropriately set the boundaries for the potential scope of arrangements subject to this measure.

To enable an apportionment exercise to be undertaken under subsection 26-110(2) and supported by objective, empirical analysis, it is critical that the term 'intangible asset' is clearly defined. This should include guidance around the reconciliation between the definition of this term and the exercise required for the application of section 26-110 and the definition and exercise adopted by other disciplines requiring similar identification and apportionment exercises, for example accounting for purchase price allocations and transfer pricing analysis. Both of these disciplines would be expected to play an important role in undertaking a reasonable apportionment exercise utilising well understood and accepted techniques. Therefore, the Draft Law and/or the EM should provide clarification around the interaction and alignment of these disciplines with the definition of 'intangibles asset' and the resultant apportionment exercise required under section 26-110.

#### **Mischaracterisation - no exploitation by Australian SGE**

Paragraph 1.11 of the EM contemplates mischaracterisation of payments and considers this to include “payments that are in substance, but not legal form, made for the right or permission to exploit an intangible asset”. This inclusion appears to adopt the concepts from ATO advice and guidance related to mischaracterisation as specifically covered in Taxpayer Alert 2018/2: *Mischaracterisation of activities or payments in connection with intangible assets (TA2018/2)* and is also inferred from yet to be finalised, and arguably controversial, commentary in Taxation Ruling TR2021/D4: *Income tax: royalties - character of receipts in respect of software*.

Paragraph 1.12 of the EM then considers a related party arrangement (taken to mean an arrangement between the SGE and one or more associates) under which there is a provision of services and right or permission to exploit an intangible asset.

Whilst it is clear there is exploitation of an intangible asset under such an arrangement, it is unclear whether the wording of the Draft Law is satisfied, that is whether the “payment is attributable to a right to exploit an intangible asset” or whether such arrangements require the Australian SGE itself to be the entity to have the right or permission to exploit an intangible asset. Notwithstanding the intended outcome, we observe that:

- If the service provider was itself the owner of the relevant intangible asset, it would not require a right to or permission to exploit the intangible asset; and
- Where such an arrangement would be caught under the Draft Law, this is wholly inconsistent with the mischaracterisation contemplated in TA2018/2.

Further clarity is required in respect of service arrangements where the Australian SGE obtains no rights to exploit, nor exploits in substance any intangible asset. Examples relating to this in the EM would also assist in determining whether there is a boundary as to the activities of the service provider. Specific examples could be related to:

- The exploitation of an algorithm or other high-value source code by a service provider to generate data that is then issued to associated entities in several jurisdictions including to an associated Australian SGE (and where the Australian SGE has no rights or access to the algorithm).
- The exploitation of high-value know-how or confidential information by a service provider to provide bespoke technical services to an associated Australian SGE (and where the Australian SGE has no right or access to the know-how or confidential information).
- The exploitation of know-how relating to efficiency or standard software by a service provider to provide routine administrative services such as invoicing services or internal people (human capital) services to an associated Australian SGE.

It is unclear why the provision of services are isolated for unique treatment and these potentially extended concepts of mischaracterisation do not extend to the provision of tangible goods where intangible assets are used, for example, in the manufacture of tangible goods with finished goods then sold to an associated Australian SGE.

### **Mischaracterisation - exploitation by Australian SGE**

As acknowledged at the start of the preceding section, concerns related to mischaracterisation were raised by the ATO in TA2018/2 in the context of royalties and the potential obligation to withholding tax. TA2018/2 also stated it would not apply to arrangements involving an incidental use of an intangible asset giving the example of the use of a brand name which appears on the good and related packaging. This example appears to align to the short example in paragraph 1.47 in the EM which considers use (taken to mean 'exploitation') comprising the "mere marketing" of a trademarked product would not be caught by the Draft Law.

Example 1.1 in the EM extends the activities undertaken in respect of the trademark to include the "branding of local retail stores" and the "prominent display" of the trademark in all marketing material. These activities are authorised through a clause in the relevant agreement which provides the Australian SGE with the right to "use any of the intellectual property necessary to fulfil its obligation to market and sell clothing and shoes". The outcome of the example is that a deduction for the payment would be denied to the extent it related to the right to exploit the trademark, but it is not clear whether the outcome is determined through the broad right provided or both the broad right provided and the activities undertaken.

The two examples above appear to show a low threshold and have the potential to create confusion as to where a boundary might lie between incidental use and more substantial use.

The Draft Law should be amended to extend the exemption under paragraph 26-110(7)(a) to include the incidental use of intangibles related to the marketing or promotion of a tangible asset. We also recommend further clarity is provided in relation to what might constitute incidental use through an explanation and further examples in the EM to cover:

- What is meant by 'mere marketing'.
- Whether incidental use would apply to any additional marketing or promotion activities (for example placing a picture of a branded product in a promotional catalogue).
- Whether there is difference between the unrestricted right to use a trademark in all marketing activities or a tightly controlled use of a trademark (for example through a catalogue of specific authorised promotional material).



### **Appendix 3 - Matters relating to practical compliance and administration**

The Draft Law introduces several broad concepts and obligations on taxpayers, which has led to considerable uncertainty and will result in a significant compliance burden for taxpayers. This, combined with the minimal consultation on the Draft Law itself or other explanatory guidance provided, makes it difficult for taxpayers to review their existing arrangements and appropriately prepare for the implementation of the intangibles integrity measure .

Below we list some key issues with the practical compliance and administration of the Draft Law, as well as some recommendations that could assist in reducing the initial and ongoing compliance burden for taxpayers with respect to the measure, without undermining its stated policy intent.

#### **Commencement of the intangibles integrity measure should be delayed**

The Draft Law proposes for the provisions to apply to any amounts paid, liabilities incurred or amounts credited on or after 1 July 2023. The Draft Law was released for public consultation during April 2023, and has created significant uncertainty and concern for taxpayers based on the numerous reasons as outlined in this submission. Taxpayers have less than three months to consider how the Draft Law could apply to their arrangements assuming the current commencement date is maintained in the final law. This does not factor in the need to consider any amendments made in the final law. This will likely result in taxpayers unknowingly being caught and punitively penalised under the integrity measure.

We strongly recommend that the final law apply at least prospectively; preferably six months after the final law receives Royal Assent. This will give taxpayers sufficient time to properly consider the application of the final law to their arrangements, and restructure in good faith where necessary.

#### **ATO guidance is required**

As we have outlined within this submission, the Draft Law introduces a number of new and broad ranging concepts in the Australian tax law, and could result in double taxation and/or a significant compliance burden on taxpayers. It is unclear as to what is expected of taxpayers in terms of complying with the Draft Law, and what preparatory action they can take to ensure their arrangements do not fall under the scope of the Draft Law.

We recommend that the ATO publish guidance products on its intended interpretation and administration of the final provisions of the Draft Law, such as Law Companion Rulings (**LCR**) and Practical Compliance Guidelines (**PCG**), preferably before commencement of the provisions, particularly with respect to the following subjects:

- Behavioural changes including restructuring arrangements to avoid application of the measure and the potential application of Part IVA of the ITAA 1936 (similar to the process undertaken in PCG 2018/7).
- Expected compliance approach for evidencing tracing and apportionment, similar to PCG 2021/5.

- The definition of a LCTJ.
- Expected interpretation of undefined terms in the Draft Law such as 'intangible asset', 'tangible asset', 'services', 'attribution' and 'related arrangement'.

### **The requirements to trace and apportion payments should be simplified**

Tracing and apportioning payments could result in a significant compliance burden for taxpayers, due to the uncertainty and broad scope of the Draft Law. Our experience with tracing in the context of the imported hybrid mismatch rule contained in Subdivision 832-H has been that tracing, for many taxpayers, can be extremely onerous, resource intensive and costly.

We would recommend that the tracing requirements be simplified and recommend that tracing not be required where:

- There is no nexus, connectedness or relatedness between payments,
- Total deductible payments from Australia to associate entities is below a set de minimis,
- Total amount of payments made to or from a jurisdiction, or turnover in the jurisdiction, in the income year is below a safe harbour threshold, or
- Payments are made to, or the UPE is based in, a jurisdiction that is not a LCTJ or other definition of a "safe" or appropriately taxing jurisdiction.

Similarly, uncertainty as to the availability and appropriate methodology for apportionment under the Draft Law could also create a significant compliance burden for taxpayers and lead to some problematic outcomes. Paragraph 1.38 of the EM suggests that apportionment would only be available with respect to "mischaracterised" payments (i.e. to the extent that the payment is attributable to the right to exploit the intangible asset), and not appropriately characterised payments that are traced to exploited income in a LCTJ. It is also unclear, for example, what approach should be taken on apportionment with respect to:

- Differing amounts of Australian and foreign income tax deductions relating to a chain of payments,
- Whether an amount of income derived in a LCTJ should be relevant in determining the amount of denied Australian deductions (i.e. \$1 of "bad" income should not result in the denial of \$1m of Australian deductions), and
- The "undertaxed" amount of the exploited income (i.e. the denial should not be the same where tax of 14% and tax of 0% is applied in the LCTJ).

#### **Appendix 4 - Other matters for consideration**

The Draft Law gives rise to several other critical issues including:

- **Need for a de-minimis threshold**

The Draft Law will apply to in-scope payments, regardless of the quantum of the payment, and will impose a significant compliance burden on taxpayers. To minimise the potential compliance burden for many taxpayers, we recommend the Draft Law includes a de-minimis threshold of \$2m (in respect of payments under an arrangement per income year) with the potential to apply the general anti-avoidance rule in Part IVA of the ITAA 1936 to any scheme that seeks to artificially circumvent the application of the Draft Law through a de-minimis threshold.

- **Providing guidance on the interaction with Double Tax Agreements**

Where a payment is made to a non-resident of a territory with which Australia has entered a Double Tax Agreement, the applicable tax treaty will need to be considered. Additional complication will arise where the direct recipient of the payment is not in a LCTJ but a deduction is denied due to where the recipient of an on-payment is in a LCTJ.

The Draft Law does not acknowledge or provide any guidance to address the interaction of any of Australia's Double Tax Agreements. Given Australia's extensive tax treaty network, we strongly recommend that the final EM address this issue, and explain the policy decision that has been made about the application of Double Tax Agreements.

In particular, we recommend coverage on the potential application of the Non-Discrimination Articles of many Double Tax Agreements including confirmation:

- As to whether the law is intended to apply only to payments from Australian residents to non-residents; and
- In referring to the Draft Law as an 'anti-avoidance rule', whether there is an intention to assert the application of carve outs to Non-Discrimination Articles in the context of the Draft Law being a provision designed to prevent evasion or avoidance of taxes<sup>6</sup> or even to address tax abuse<sup>7</sup>.

We acknowledge that this request may be challenging because not all of Australia's Double Tax Agreements are identical. However, the ATO has previously provided general guidance in relation to the operation of Double Tax Agreements and particular forms of income<sup>8</sup>.

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<sup>6</sup> For example as defined in Sub-Paragraph 7(1) of the Protocol to the Double Tax Treaty between Australia and Germany.

<sup>7</sup> For example, as included in Paragraph 13 of the Protocol to the Double Tax Treaty between Australia and Switzerland.

<sup>8</sup> For example, TR2001/12 (withdrawn on 13 October 2010) dealt with the capital gains tax in the context of pre-CGT treaties.

- **Interaction with other legislative provisions within the Australian Tax Acts - ordering**

Due to the short consultation period, it has not been possible to identify all potential conflicts or inconsistencies that may arise between the Draft Law and the operation of other domestic tax laws. The Draft Law does not provide any clarity or guidance on how it will interact with other domestic tax laws, either primary or secondary impacts, including, for example, whether it will be applied in priority to the general anti-avoidance rules and DPT contained in Part IVA of the ITAA 1936 and/or the hybrid mismatch rules contained in Division 832 (which may equally apply to deny deductions).

If the Draft Law does not operate as a provision of last resort, then the administrative safeguards associated with integrity rules that contain purpose tests and Australia's general anti-avoidance rules (see ATO Practice Statement Law Administration 2005/24) will not be in place.

Consideration must be given to the interaction and ordering of the intangible integrity measure with other "priority" integrity rules such as the general anti-avoidance rules contained in Part IVA of the ITAA 1936, the transfer pricing rules contained in Division 815, withholding tax provisions, hybrid mismatch provisions etc. Given the potential for significant overlap, an ordering rule along with detailed guidance should be developed outlining which rules take precedence in situations where overlap may exist. Without this, uncertainty and increased compliance costs for both taxpayers and the ATO will arise.

- **Interaction with other provisions - liability to withholding tax**

The Draft Law will result in payments of royalties which are made to a LCTJ or trace through to a LCTJ being subject to both a deduction denial and the corresponding income liable to withholding tax. This will result in an aggregate liability of up to 60% in respect of the payment.

Further to the comments on withholding tax earlier in our submission on the determination of a LCTJ, we strongly recommend that consideration is also given as to whether this aggregated liability is appropriate and required given the policy intent to "*prevent large multinationals from securing an unfair tax advantage over other Australian business*"<sup>9</sup>. Alternatively, amounts subject to Australian RWHT could be excluded from this new measure.

- **Behavioural Change**

The explanation to the Parliamentary Budget Office costings for the measure<sup>10</sup> included reference to an anticipated behavioural response. However, no details have been provided in

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<sup>9</sup> Paragraph 1.2 of the Explanatory Materials.

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[https://www.aph.gov.au/About\\_Parliament/Parliamentary\\_departments/Parliamentary\\_Budget\\_Office/General\\_elections/2022\\_General\\_election/2022\\_Election\\_commitment\\_costings](https://www.aph.gov.au/About_Parliament/Parliamentary_departments/Parliamentary_Budget_Office/General_elections/2022_General_election/2022_Election_commitment_costings)

either the August 2022 consultation paper or the Draft Law as to what behavioural response is anticipated.

The introduction of other anti-avoidance regimes, such as the hybrid mismatch rules, have outlined the expected changes in taxpayer behaviour due to the introduction of these regimes, and where restructuring or new arrangements were entered into to avoid the application of these regimes, what were the desired and appropriate outcomes for these restructured and new arrangements.<sup>11</sup>

There are potential behavioural responses which might include, for example, a transfer of group intangible assets out of a LCTR or a separation of intangible assets and transfer of Australian specific intangible assets out a LCTJ. Such transfers may result in payments to the intangible asset owner by an Australian SGE out of the scope of the Draft Law. However, clarity is required as to:

- Whether or not the ATO may seek to apply Part IVA of the ITAA 1936 to such a response, notwithstanding the change could be aligned to the policy intent; and
- Whether or not any risk will arise, as contemplated in Taxpayer Alert TA2022/2: *Treaty shopping arrangements to obtain reduced withholding tax rates* where the outcome from the transfer is a reduced withholding tax rate on income received from payments made by the Australian SGE.

We also note that under the UK Offshore Receipts in respect of Intangible Property (**ORIP**) Rules, which was considered as part of the measure's design,<sup>12</sup> contain a targeted anti-avoidance provision (**TAAP**) for arrangements entered into for the "main purpose" of obtaining a tax advantage through circumventing the ORIP Rules.<sup>13</sup> However, HM Revenue and Customs (**HMRC**) acknowledges that the ORIP Rules aim to:<sup>14</sup>

*"discourage multinational businesses from holding intangible property in low tax territories distinct from the territories in which the substantive economic activities that relate to its development, enhancement, maintenance, protection and exploitation are located, and where little or no tax is paid on the income received"*

Consequently, HMRC's published guidance as to the application of the TAAP, acknowledges this underlying desired behavioural change of the ORIP Rules.

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<sup>11</sup> See paragraphs 1.20-1.21 of the revised Explanatory Memorandum to the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018.

<sup>12</sup> The Treasury 2022, *Government election commitments: Multinational tax integrity and enhanced tax transparency - Consultation Paper*, Australian Government, accessed April 2023, <https://treasury.gov.au/sites/default/files/2022-08/c2022-297736-cp.pdf>

<sup>13</sup> Section 608W of the *Finance Act 2019* (UK).

<sup>14</sup> HMRC 2023, *INTM620510 - Offshore Receipts in respect of Intangible Property (ORIP): General: Anti-avoidance*, UK Government, accessed April 2023, <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm620510>

We strongly recommend that the Draft Law provides details on what behavioural change is anticipated, what behavioural change is desired and what behavioural change will be accepted.

Specifically, clarification is required in relation to the non-application of Part IVA of the ITAA 1936 to affected taxpayers who restructure to avoid the punitive application of the intangible integrity measure. Further we recommend that the ATO publish administrative guidance as soon as possible after substantial enactment occurs.

- **Penalties**

We note the request for stakeholder views on penalties as per paragraph 1.40 in the EM.

We consider the existing framework for shortfall penalties to be appropriate for any non-compliance with the Draft Law. Penalties associated with this measure should not be increased beyond the current arrangements contemplated in Australian tax laws.

Additionally, we consider it appropriate and strongly recommend that reduced penalty rates apply for a period of at least 12 months to allow taxpayers time to evaluate any reasonably arguable position adopted. This should allow sufficient time for advice and guidance to be drafted and published by the ATO in order to provide clarity on how they intend to administer the law, and in particular consider concepts that are relevant to the apportionment exercise contemplated by the Draft Law.